Statement of Thomas A. Bowman, CFA
President and Chief Executive Officer
The Association for Investment Management and Research
U.S. House of Representatives
Committee on Financial Services
Capital Markets, Insurance, and Government Sponsored Enterprises Subcommittee
Analyzing the Analysts: Are Investors Getting Unbiased Research from Wall Street?

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➢ Opening Remarks

Good morning, my name is Thomas A. Bowman, President and Chief Executive Officer of the Association for Investment Management and Research® (AIMR®) and holder of the Chartered Financial Analyst® designation. I would like to thank Congressman Baker and members of the committee for the opportunity to speak on this important issue on behalf of the more than 150,000 investment professionals worldwide who are members of AIMR or are candidates for the Chartered Financial Analyst (CFA®) designation, most of whom are not subject to the conflicts under discussion today.

➢ Background on AIMR

AIMR is a non-profit professional membership organization with a mission of advancing the interests of the global investment community by establishing and maintaining the highest standards of professional excellence and integrity. AIMR is most widely recognized as the organization that conducts qualifying examinations and awards the CFA designation. In 2001, over 86,000 candidates from 143 countries registered to take the CFA exam.

CFA charterholders, candidates, and other individuals who are AIMR members subscribe to a *Code of Ethics and Standards of Professional Conduct* that require them, among other things, to:

(1) Exercise diligence and thoroughness in making investment recommendations;
(2) Have a reasonable and adequate basis, supported by appropriate research and investigation, for such recommendations or actions;
(3) Use reasonable care and judgment to achieve and maintain independence and objectivity in making investment recommendations or taking investment action;
(4) Act for the benefit of their clients and always place their clients' interests before their own;
(5) Distinguish between facts and opinions in the presentation of investment recommendations; and
(6) Consider the appropriateness and suitability of investment recommendations or actions for each client.

Although AIMR members are individuals rather than firms, AIMR has had success with development and implementation of the AIMR Performance Presentation Standards™ (AIMR-PPS™) and the Global Investment Performance Standards™. These standards require firm-wide compliance and have been embraced by the global investment industry. Based on our experience, I can tell you that ethical standards are most effective when voluntarily embraced rather than externally and unilaterally imposed. AIMR is firmly committed to developing and recommending practical, long-term solutions for the conflicts that research analysts face and for the ethical dilemmas that we are discussing today.

Since investment professionals work in a global marketplace, implementation of a domestic standard in the U.S. would solve only part of the problem. As a global organization, AIMR is in a unique position to effect positive change throughout the world.

- **Analyst Independence**

Clearly, deteriorating investor confidence in the independence and objectivity of sell-side research reports and recommendations does NOT advance the interests of the global investment community. Before we discuss this important issue, however, we first must understand that analysts do not work in a vacuum. The pressures to provide positive research reports and favorable investment recommendations come from many sources, not all of them internal to their firms. Before we can develop solutions to reduce their impact on the research process, we first must identify and expose not only the pressures but also the contributors and processes that cause them.

It is important to recognize that the conflicts that sell-side analysts face are not new. But the pressures on the analyst have escalated in an environment where penny changes in earnings-per-share forecasts make dramatic differences in share price, where profits from investment-banking activities outpace profits from brokerage and research, where the demographics of the investors who use and rely on sell-side research have shifted, and where investment research and recommendations are now prime-time news.

The particular conflict posed by analysts' involvement in their firms' investment-banking activities has been the focus of recent media attention. But this is by no means the only conflict that we must address if we are to provide an environment that allows analysts to operate without undue or excessive pressures to bias their reports and recommendations. Pressure to prepare "positive" reports and make "buy" recommendations may also come from corporate issuers and institutional clients who may have their own vested interests in maintaining or inflating stock prices. An investment professional's personal investments and trading pose another conflict, one that AIMR addressed extensively in a 1995 topical study that now forms an important component of our *Code and Standards*. Human factors also affect the content and quality of a research report or investment recommendation. Analysts are not infallible, after all, even when independent and objective.

Let me elaborate a bit on some of these pressures. We do not dispute that some sell-side firms pressure their analysts to issue favorable research on current or prospective investment-banking clients. However, the relationship between the research and investment-banking functions is symbiotic. Analysts need to work with their investment-banking colleagues to help evaluate prospective clients. They also sometimes participate in marketing activities to support securities offerings of companies they recommend. Although we do not believe that this collaborative relationship is inherently unethical, the investment-banking firm must take particular care to have policies and procedures that minimize, manage effectively, and adequately disclose to investors any and all potential conflicts.

Effective management of these conflicts requires firms to:

(1) Foster a corporate culture that fully supports independence and objectivity and protects analysts from undue pressure from investment-banking colleagues;
(2) Establish or reinforce separate and distinct reporting structures for their research and investment-banking activities so that investment banking never has the ability or the authority to approve, modify, or reject a research report or investment recommendation;
(3) Establish clear policies for personal investment and trading to ensure that the interests of investors are always placed before analysts' own;
(4) Implement compensation arrangements that do *not* link analysts' compensation directly to their work on investment-banking assignments or to the success of investment-banking activities; and
(5) Make prominent and specific, rather than marginal and "boilerplate," disclosures of conflicts of interest.

In addition to pressures within their firms, analysts can also be, and have been, pressured by the executives of corporate issuers to issue favorable reports and recommendations. Regulation "Fair Disclosure" notwithstanding, recent history, supported by the results of a research study issued by Reuters, has shown that companies retaliate against analysts who issue "negative" recommendations by denying them direct access to company executives and to company-sponsored events that are important research tools. Companies have also sued analysts personally, and their firms, for negative coverage. Such actions create a climate of fear that does not foster independence and objectivity.

Institutional clients may also pressure analysts to issue positive reports. In the short-term, stock prices are often very sensitive to rating changes. Portfolios with significant positions in a particular security may be adversely affected by a rating downgrade. Poor portfolio performance may have a subsequent negative impact on the portfolio manager's performance evaluation and compensation. Consequently, some portfolio managers support sell-side ratings inflation and may retaliate against analysts they perceive as "negative" by shifting brokerage to another firm or by reporting those analysts to the company in question, thus launching the corporate retaliation mentioned earlier.

All of these conflicts are discussed at length in a position paper that AIMR will soon issue for public comment and which will form the basis for our development of AIMR Research Objectivity Standards. These standards will promulgate best practices for addressing each of these conflicts and we will call upon analysts themselves, their employers, issuers, investors, and the media to assist in their development and to support and adopt them when issued. Again, I point to the successful implementation of investment performance standards as a precedent to show that a voluntarily embraced standard—which is the model we will recommend with the AIMR Research Objectivity Standards—has the greatest likelihood of creating effective, long-term solutions for the issues we are discussing today. Although AIMR, as an individual membership organization, cannot require firms to adopt these standards, we believe that competitive forces similar to those that led to adoption of AIMR-PPS in the United States and Canada will come into play here as well.

- **Communication of Research Reports and Recommendations**

Finally, we must address the ways in which research and recommendations are communicated to investors, particularly the investing public. How and by whom recommendations are communicated can seriously impair an investment professional's ability to fulfill his or her responsibility to know each client and to assess the suitability and appropriateness of a particular investment given the client's investment objectives and constraints. All of these vital issues are addressed in the AIMR *Code of Ethics and Standards of Professional Conduct.*

Increasingly, private investors are demanding and accessing research reports and recommendations through their brokers, the media, and the Internet. Although a typical research report is many pages in length, these intermediaries often condense the report to its "bottom line"—an earnings forecast or a buy, hold, or sell recommendation. Although this makes a good sound bite—and we can't keep people from trading on headlines—investors need to be informed, and should understand that headline ratings or recommendations do not provide sufficient information to justify buying or selling a security.

Investment research is multi-faceted and investment decision-making can be complex. Research results that are over-simplified not only lose their value, but they also may have a detrimental impact on the investment decision-making of those who rely on them. Brokerage firms, the media, and other investor-information providers should review and revise, if necessary, the form and content of their communications. At a minimum, they should urge investors to become familiar with entire reports before assessing, either on their own or with a professional advisor, whether the recommendation is appropriate to their particular situations, investment objectives, and constraints before taking any investment action.

The AIMR Research Objectivity Standards will also address how best to communicate research and recommendations effectively in order to provide comparable, transparent, and useful information on which investors of all levels of sophistication and knowledge about the investment process can reasonably rely.

- **Closing Remarks**

In closing, I would like to impress upon the committee that AIMR and its members appreciate the seriousness of the problem facing research analysts, but also its complexity. A precipitous solution is not the answer. We believe that the profession can address the issues and develop effective, workable solutions. We are confident that the AIMR Research

Objectivity Standards can be that solution if embraced and adopted by those who have a stake in preserving the integrity of research and the professionals who conduct it.

I will be happy to answer any questions that you might have. Thank you.